Optimize Your Forecasting: Improving the Crystal Ball

Forecasting is always at the top of Treasury's to-do list – either implementing a good forecast process or improving what already exists. There are numerous benefits, and *with a little help, it can be less complicated than you think.*

Cash Position vs. Other Forecasting

There are multiple kinds of financial forecasts, and things that masquerade as forecasts that really aren't. So let's lay out some definitions.

Treasury is primarily concerned with what we call the "cash position forecast." The purpose of this daily short-term forecast is (a) to ensure the firm has adequate liquidity and (b) to support short-term investment and borrowing decisions.

In lieu of a true cash position forecast, some firms do a "cash calendar." Known cash flows and large, scheduled items (tax payments, RE sale proceeds, etc.) are entered into a calendar spreadsheet. Some elaborate calendars incorporate emailed information of major cash flows from business units. These calendars are not forecasts, but have been adequate substitutes in an extremely low rate environment.

Neither cash position forecasts nor cash calendars should be confused with intermediate-term to long-term forecasts that project the size and composition of the balance sheet and capital structure. Their purpose is to guide decisions such as the level and type of intermediate-term and long-term debt, when to enter markets, and when to raise debt vs. equity. Such balance sheet forecasts are also of great importance to the firm, because they would be shared with analysts, shareholders and regulators.

Every company also has business forecasts, which include bottom-up budgets and growth forecasts.

The Benefits of Good Cash Position Forecasting

Why do you need a cash position forecast, or a better one, or something more than a cash calendar? Why is there so much topical interest in forecasting right now?

Part of the answer lies with "end of an era" interest rate changes that began as this article was being written. While rates were zero, the opportunity cost of poor forecasting was, for many companies, very low. More robust, pre-crisis forecasting processes were allowed to atrophy.

But with the first Fed rate hike in almost a decade, the opportunity cost of bad forecasting suddenly rises, and will in all likelihood increase for the next few years. Rate hikes historically occur in a long series, so we can expect the interest component of forecasting value to be on a steady climb.

A good cash position forecast allows you to be more precise in structuring your short-term investments and go further out on the yield curve. It will help you determine a minimum cash position over the relevant time frame, so you can keep as much invested as possible. And it creates certainty that no unexpected outflows drive unfavorable investment liquidations. In short, a good cash position forecast helps you optimize your liquidity.

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Why Do Some Companies Succeed and Others Not?

In our advisory work, we see some leading practices that allow the cash position forecast to be all it can be:

1. **Defining a scope that's both manageable and sufficient to achieve objectives**
   Sometimes the scope is too broad – it's not unusual to see a failed forecast that tried to boil the ocean. It may be too precise; if it makes no difference whether you forecast a $50 million cash need, or a $50.25 million need, why drive the process for precision that isn't useful?

   Often, a forecast starts out with too much granularity, for no other reason than that it can. It may be designed to use the expected cash flow from individual product groups, rather than business units; or to require forecasts of payroll, office expenses and overhead rather than total SG&A.

2. **Defining inputs that can be reliably and simply obtained**
   Yes, some data will probably have to come from other departments. To the extent this can be automated, your forecast has a greater chance of success.

   And to the extent it cannot be automated, it is helpful to have default variables that can be substituted if a human source fails. Keep in mind – if you rely on emailed data, or phone calls from various departments, the last person sending data determines when you can complete the forecast.

3. **Doing variance analysis**
   This is less about ticking and tying, and more about following signals that can improve your forecast.

   As we suggest in the next section, variance analysis can show you what parts of the forecast are fine as they are (small variances), and what parts may need to be more granular or use different data (large and repeating variances).

   Large variances can also be signals of something interesting going on: a new trend, a change in payment patterns, a sign of sector stress. Any of these would be valuable to uncover and incorporate in the ongoing forecast.

4. **Incorporating only related variables**
   Cash Position Forecasting and Balance Sheet Forecasting differ in the kind of variables that have relevance. For example, a balance sheet forecast might incorporate commodity price or GDP projections as key variables. While these could affect relevant variables like interest rates, they would have almost zero impact during the time horizon of the cash position forecast.

   Nonetheless, sometimes such variables are injected into the cash position forecast, to no advantage and with the disadvantage of unnecessary complication.

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Some Counterintuitive Suggestions

We advise companies to start (or refine) their cash position forecasts with a fairly straightforward process, and layer on more sophistication as required – rather than "pulling out all the stops" on day one.

Realize that your forecast process development is iterative and expect that it will improve over time. Give it several rounds to settle in. Diligent variance analysis is absolutely key – it will direct you where to add more precision or make changes. For example, if a business unit always has a positive variance, you may need different source data, or different coefficients or adjustment factors.

Apply statistical processes with the right level of granularity and flexibility. You may be surprised that many of your items can be very simple to forecast. Simple patterns are often effective and can be easily tested – day of week, week of month, growth cycles from prior periods, same day prior month, etc.

Summary

The U.S. economy has just emerged from a long zero-rate era, and is now in what will undoubtedly be several years of gradual rate increases. This intensifies the importance of a good cash position forecast. Companies that have let their forecasting lapse, or that have relied on cash calendars, need to reinstate a forecasting discipline.

This is less complex and more doable than you may realize. We can help you set proper objectives, defining a balance between manageability and value. You don't need to be overambitious on day one if you realize your forecast will improve over time, with diligent variance analysis that delivers the precision you need.

We help our clients define achievable objectives, set the right scope, use the proper methodology and select and implement the proper tools.

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